

*Research paper***The debt bias in company financing decisions - problems and possible solutions***Submitted in 28, April 2023**Accepted in 04, May 2023**Evaluated by a double-blind review system***NELLY POPOVA^{1*}****ABSTRACT**

Purpose: The purpose of the present article is to compare the relative strengths and weaknesses of thin capitalisation rules and allowances for corporate equity which are the main approaches used in modern tax systems to address the debt bias and have been an integral part of proposals for international coordination of corporate income taxation.

Methodology: The theoretical methods applied in the article are review of the existing literature on the topic and comparative analysis of the strengths and weaknesses of the main approaches to the debt bias.

Results: Although thin capitalisation rules and allowances for corporate equity contribute to the reduction of the problems associated with the debt bias, both types of methods have their limitations. The two approaches are analysed in the article from the perspective of international reform proposals within the BEPS project and the EU as the effective elimination of the distortions caused by the debt bias can be achieved only in coordinated manner.

Originality: The paper adds to the growing body of literature on the topic by summarising the main strengths and weaknesses of the two main methods for resolving the debt bias and analysing them from the perspective of the reforms of international tax rules.

Keywords: Corporate income taxation, Debt bias, Thin capitalisation rules, Allowances for corporate equity, International tax coordination

1.Introduction

Corporate income taxation (CIT) has important implications on business activities and profitability. Existing international tax rules, which date back to the beginning of the previous century, aim at creating incentives for companies to invest and grow. However, some aspects of CIT are no longer fully compatible with modern economic realities characterised with strong capital mobility and rapid development of the digital economy. The present paper is devoted to one aspect of international tax rules, namely the so-called

^{1*} Corresponding author. University of National and World Economy, Bulgaria. E-mail: npopova@unwe.bg

debt bias in corporate financing decisions that results from the uneven tax treatment of debt and equity. Although the deductibility of interest on corporate debt for tax purposes has a long tradition, there has been recognition of the distortions arising from extensive borrowing by companies. Moreover, preferential tax treatment of debt is a source of financial risks in the context of globalisation and the increasing power of multinational enterprises (MNEs). Therefore, in recent years, there have been considerable efforts in CIT reforms to address the debt bias within the framework of OECD/ G-20 as well as the EU.

Against this background, the purpose of the article is to analyse and compare the two approaches that are applied throughout the world, namely interest deductibility limitations and allowances for corporate equity. Both methods are successfully applied and contribute to the reduction of the debt bias but each of them has its weaknesses.

The paper is structured as follows: section two presents the background of the debt bias and outlines the main risks associated with it. Section three is devoted to the development of thin capitalisation rules which are the predominantly used approach for reduction of the debt bias in most countries and have become the international standard. Section four presents the allowance for corporate equity which is viewed as a practicable way to ensure neutrality with regard to company capital structure and compares it with thin capitalisation rules. Section five concludes the main findings of the article.

2. Legal and theoretical background of interest deductibility

According to the established tax practice throughout the world interests on all types of borrowed funds can be deducted from profit before corporate income taxation (CIT). In contrast, dividends paid out to corporate shareholders are not treated as a tax deductible expense. What is more, in many countries dividends are subject to an individual income tax which results in double taxation of company earnings. Due to the preferential tax treatment of interests, financing with debt becomes more attractive for businesses to finance their investments than equity as it increases profitability. When interest deductibility is taken into account, the value of a leveraged firm is equal to the value of an unleveraged firm, augmented by the tax shield value of debt. This tax shield represents the tax advantage and equals the amount of debt times the corporate tax rate. Hence, a company could in theory maximize its value by being financed 100 per cent via debt (Fatica, Hemmelgarn, & Nicodème, 2013).

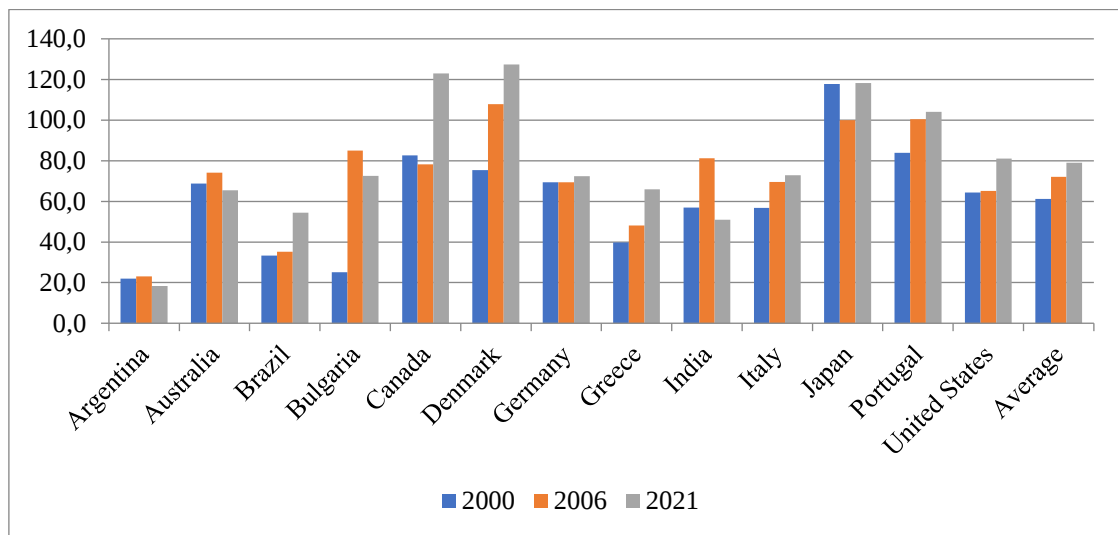
Interest deductibility for tax purposes has a long tradition. In the United States, it dates back to the beginning of 20th century when the corporate income tax was initially introduced but even then it was a contentious issue (Bank, 2014). Preferential tax treatment of borrowing over equity has no solid theoretical foundation although the obvious reason is to alleviate the debt service for businesses and increase their incentives to invest. Deductibility is justified also on the grounds of avoiding double taxation of interests because in many countries interest income is subject to taxation, as most other types of capital (passive) income. According to De Mooij (2011, p. 10) the original rationale to allow a deduction for only debt was that interest is a cost of doing business and equity returns reflect business income and this idea is reflected in international accounting principles, which view interest (but not equity returns) as a cost to the firm. However, in economic terms, both payments represent a return to capital and there is no a priori reason to tax one differently from the other.

The literature on the topic has identified also other considerations driving firms' capital structure, such as the reluctance of existing shareholders to allow dilution (Luca & Tieman, 2016, p. 3). The nontax reasons why companies choose to finance their investments with borrowing instead of equity include also agency and bankruptcy costs as well as asymmetric information (Fatica et al., 2012, p. 6). Focusing their research on banks and non-bank financial intermediaries (Luca & Tieman, 2016, p. 22) concluded that the debt bias has a strong effect on the capital structure of all types of financial institutions, especially banks. These authors also found that the largest banks, which are more important from a financial stability perspective, are precisely the ones that are most leveraged. Addressing the issue from a different angle, Petutschnig and Rünge (2022, p. 600) argued that an important reason preventing firms from increasing their equity ratios is investors' demand for dividends. Furthermore, the effects of interest deductibility can interplay with other aspects of company taxation. High corporate income tax rates, in particular, create an incentive for companies to finance their investments with debt rather than equity (Locher, 2021). Statutory CIT rates have been on a continued downward path in the past decades and when combined with full interest deductibility they can significantly reduce tax liabilities for highly leveraged businesses.

Although the effect of tax considerations on companies' capital structure cannot be entirely separated from that of other factors, there is a clear upward trend in the levels of corporate debt throughout the world (Figure 1). This fact raises concerns due to several

reasons. In the first place, the predominance of borrowed funds at the expense of own financial resources in the capital structure put at risk the leveraged companies themselves. Namely because of the credit risk associated with debt financing, the latter is also known as thin capitalisation. Moreover, high levels of indebtedness of businesses increase systemic risk, thus endangering the financial stability of the entire economy.

Figure 1. Corporate debt to GDP in selected countries



Source: IMF

Luca and Tieman (2016, p. 3) pointed out that financial companies stand out in this respect because of the strong negative spillover effects arising from their financial distress and because of the lower buffers that these companies typically have against adverse shocks due to the specifics of their business activities. The global financial crisis indeed demonstrated that high leverage among companies, in particular financial institutions, could lead to serious economic consequences if refinancing options essentially dry up overnight (European Commission, 2013, p. 62). Following the COVID-19 pandemic this issue has become even more pressing as the stock of debts of companies has increased significantly due to the economic crisis triggered by the pandemic (European Commission, 2021, p. 11). As it has proven in the past decade, corporate debt, especially in the case of large financial institutions, can transform into public indebtedness.

The debt bias itself erodes tax bases and this concern has grown with the development of hybrid financial instruments that have the characteristics both of equity and debt, such as preference shares, convertible bonds, subordinated debt and others. Hybrid instruments, particularly when used by financial institutions, have made tax laws increasingly complex

because rules are required to determine whether payments are deductible for CIT or not (De Mooij, 2011, p. 9).

Furthermore, from an efficiency point of view asymmetric tax treatment of debt and equity causes economic distortions. Most importantly, it discourages new investments which results in lower productivity and wages. As investments are driven by the cost of capital, CIT increases the expected rate of return on an investment, thus rendering some additional investment projects unviable (Kumar et al., 2022, p. 3).

Finally, in an international context, the preferential tax treatment of interests has been identified by the Organisation for economic cooperation and development (OECD) as one of the main and most simple channels used by multinational enterprises (MNEs) for international tax planning. Profit shifting can arise both from arrangements using third party debt, for example where one entity or jurisdiction bears an excessive proportion of the group's total net third party interest expense and intra-group debt, where a group uses intra-group interest expense to shift taxable income from high tax to low tax jurisdictions). The opportunities of MNEs to reduce their overall tax liabilities by shifting debt to their subsidiaries in other countries create competitive distortions between corporate groups operating in the domestic market and those operating internationally (OECD, 2017). Profit shifting through interest deductibility results in tax base erosion and loss of fiscal revenue for the countries where MNEs actually operate and generate their profits.

3.Developments in thin capitalisation rules

The predominant method used throughout the world to mitigate the debt bias in corporate finance decisions has been through the introduction of limitations on interest deductibility for tax purposes. Thin capitalization rules have a long history. In the United States, corporate interest deduction was capped as early as 1909, due to fears that shareholders could shift their investments into bonds, but several years later the cap was abolished (Bank, 2014). The massive proliferation of thin capitalisation rules began at the end of the 20th century. The original type of rule, referred to as *safe-haven ratio*, specifies a threshold for the ratio of internal debt relative to equity beyond which interest expenses are no longer deductible from the corporate tax base commonly (De Mooij & Liu, 2021, p. 4).

From a fiscal point of view, the application of limitations on interest deductibility implies an increase of the taxable earnings of companies and thus more budget revenue at any tax rate. This is an important advantage considering the increasing necessities of governments for financial resources to cover their expenditure. Increasing the tax base of CIT is also a compensatory measure to the rate cuts that have been observed throughout the world in the past decades.

Thin capitalisation rules have been successful in reducing the debt bias in corporate finance decisions. In an empirical study, Blouin et al. (2014, p. 20) established that the presence of restrictions of an affiliate's ratio of overall debt to assets reduces the leverage by 1.9%. However, according to these authors the impact of thin capitalisation regimes depends strongly on their specific organisation. Significant differences have been observed in the rules applied across countries, with regard to the restrictions on the tax deductibility of interest on company debt, in the discretion that authorities have in applying these restrictions, and in the alternative tax treatment of company interest that is applicable in case full interest deductibility is denied (Blouin, Huizinga, Laeven, & Nicodème, 2014, p. 7).

Therefore, the establishment of a common framework for interest deductibility has been among the tasks of the Base Erosion and Profit Shifting (BEPS) Project of the OECD and G-20, which was launched at the beginning of the 2010's. The project's overall purpose is to modernise the legal framework for taxation of multinational companies and to guarantee a fairer distribution of the revenues from their taxation among the countries in which these companies operate. The BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century (OECD, 2017, p. 5). In particular, Action 4 of the BEPS project aims at introducing a best practice approach to interest deductibility. The recommended approach is based on an *earnings stripping rule*, i.e. setting a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profit measured with earnings before interest, tax, depreciation and amortisation (EBITDA). Such a rule links an entity's net interest deductions to its level of economic activity within a given jurisdiction. Limitations which are known as and restrict interest deductions to a set percent of income. This approach has become the international standard in thin capitalisation rules. Following BEPS recommendations, in recent years many countries have introduced limitation of interest deductions to 30 percent of EBITDA combined with a de minimis threshold of EUR 3 million for

deductible interest expenses (Pomerleau, Bunn, & Locher, 2021, p. 12). Among these countries are the United States and EU countries where the earnings stripping rule according to the BEPS recommended approach was made compulsory with the Anti-tax avoidance directive (ATAD). As of 2023 Ireland is the only EU country that has not yet enforced the limitation.

Nevertheless, no country has moved toward full elimination of interest deductibility because abolishing it would indeed eliminate debt bias but it would also introduce new distortions into investment (De Mooij, 2011). In an empirical study De Mooij and Liu found that the introduction of thin capitalisation rules has negative effects on MNE investments which can discourage their strict application (De Mooij & Liu, 2021). Moreover, thin capitalisation rules cannot entirely remove the distortions caused by the preferential tax treatment of debt in an increasingly globalised world. As Kayis-Kumar (2015, p. 13) pointed out, thin capitalisation rules aim to prevent the erosion of tax bases of a particular jurisdiction and rather than introducing or tightening thin capitalisation legislation, which tackles only the “symptom” of debt shifting, it is more effective to eliminate the incentives for thin capitalisation by aligning the tax treatment of debt in equity.

4. The allowance for corporate equity as the main alternative

The economic literature has come up with several proposals for alternative tax regimes aimed at ensuring tax neutrality towards the capital structure of companies but the only alternative that has found practical application is the so-called *allowance for corporate equity (ACE)*. The ACE system was originally proposed in 1991 by the Institute of Fiscal Studies and was based on an earlier study of Boadway and Bruce (1984) who suggested an allowance for corporate capital (ACC). The ACC differs from the ACE in that it removes the interest deductibility and instead introduces an allowance of the normal return applied to the entire firm’s capital (Devereux and de Mooij, 2011, p. 11). As the name suggests, this type of tax regime retains the existing deductions for interest payments but also applies a tax relief for equity financing by exempting a normal rate of return from corporate taxation (European Commission, 2013, p. 63). As of 2023, the ACE system has been applied in relatively few countries, including Austria, Belgium, Brazil, Croatia, Cyprus, Italy, Latvia, Portugal, and Turkey. Despite its relatively limited proliferation in the world, the ACE system has received significant academic interest and

has even been supported by the European Commission. An up-to-date overview of the existing ACE regimes with their specifics in individuals countries can be found in Kayis-Kumar et al. (2022, p. 12-13).

The main advantage of an ACE is that it stimulates investment by reducing the marginal effective tax rate for investment to zero, while continuing to tax existing capital and economic rents (Kayis-Kumar, Rose, & Breunig, 2021, p. 8). Devereux (2012, p. 16) pointed out that the additional capital available to companies when an ACE is in place, contributes also to labour productivity, which in turn increases the demand for labour and results in higher employment, higher wages, and hence an increase of GDP. Empirical results confirm also that ACE tax systems increase equity ratios and decrease debt ratios of firms. However, according to Petutschnig & R nger (2022, p. 602) the size of this effect varies substantially across different ACE tax systems due to the different base for the allowance which in some countries include the whole book value of equity whereas in others it covers only the annual increase in equity. These authors point also to other factors determining the effectiveness of this regime, such as companies' ownership structure and dividend policies (Petutschnig and R nge, 2022, p. 633).

Despite its benefits, the ACE system does not eliminate all types of economic problems caused by the differential tax treatment of debt and equity and may itself be the source of distortions. In particular, the application of an allowance for corporate equity narrows the tax base; hence, it may require higher tax rate in order to maintain revenue neutrality. De Mooij (2011, p. 18) estimated that base narrowing through an ACE has a direct estimated revenue cost of approximately 15 percent of CIT revenue, or 0.5 percent of GDP, but this cost can be reduced significantly by accompanying measures. According to Devereux & De Mooij (2011, p. 9) location decisions are relatively responsive to effective average tax rates and for this reason it is attractive to individual countries to broaden their tax base and cut the CIT rate. From this perspective, the ACE system does not remove the bias in location decisions and profit shifting by multinational enterprises (MNEs) and it may even exacerbate the problems related to tax avoidance. Another drawback is that ACE-based reforms risk creating distortions regarding organisational form because the application of this regime is limited to corporate structures. It may encourage individuals with businesses to incorporate rather than pay tax through the personal income tax system (Kayis-Kumar et al., 2022, p. 10).

Given the relatively successful implementation of ACE regimes in several countries, in 2022 the European Commission initiated a project for a *debt-equity bias reduction allowance (DEBRA)* to be introduced in the EU. The proposed reform consisted of two independent elements: an allowance on equity and a limitation to interest deduction. The allowance was envisaged to be calculated as the year-on-year increase in equity multiplied by a notional interest rate and to be granted to taxpayers for a period of ten years. Furthermore, to prevent tax abuse the deductibility the allowance would be limited to a maximum of 30% of taxpayer's EBITDA (European Commission, 2022, p. 9). The Commission's proposal also contained an interest limitation rule which would allow addressing the debt-equity bias simultaneously from both the equity and the debt side (European Commission, 2022 p. 10). At the end of 2022, however, the negotiations on the DEBRA proposal were temporarily suspended by the Council of the EU due to the necessity of its reassessment. During the consultation process on the legislative proposal some stakeholders expressed their concerns to some aspects of the project, such as further limitations of interest deductibility for small and medium enterprises, and Sweden rejected it on the basis of tax sovereignty of the Member States (European Parliament, 2022). The DEBRA project was proposed as part of a wider reform package of company taxation that reflects the long-time ambitions of the Commission to achieve closer coordination among the Member States in the area of CIT. The so-called Business in Europe: Framework for Income Taxation (BEFIT) has as its main purpose to introduce a single corporate tax rulebook for the EU including the key features of a common tax base and the allocation of profits between Member States on the basis of a formula (European Commission, 2021, p. 11).

The BEFIT proposal is not entirely new because its essential component, namely the formulary apportionment of profits of MNEs among the EU countries, was at the core of the project for introduction of a Common Consolidated Corporate Tax Base (CCCTB) launched by the European Commission in 2011. At the time, the proposal did not receive the necessary unanimous support by the Member States. According to Devereux (2012) the introduction of common rules for CIT in the EU would not solve the existing problems with profit shifting and tax avoidance. With regard to the initial Commission's project for the CCCTB, this author noted that its most advantageous element is that it would remove the incentive to shift profits between EU countries. On the other hand, the incentive to shift profits out of the EU would remain. The Commission's BEFIT legislative initiative

builds on the progress in the global discussions for reforms within the BEPS project. In particular, the partial reallocation of MNEs' profits is consistent with Pillar 1 whereas the introduction of common rules for calculating the tax base is related to the purposes of Pillar 2 (European Commission, 2021, p. 12). The proposal for introduction of BEFIT is scheduled to be put to the table for discussion by the end of 2023 (European Parliament, 2023).

The main effects of thin capitalisation rules and ACE system are summarised in Table 1. Both approaches mitigate the issues arising from the asymmetrical treatment of debt and equity have relative strengths and weaknesses.

Table 1. Comparison of thin capitalisation rules and allowances for corporate equity

	Thin capitalisation rules	Allowances for corporate equity
Fiscal effects	Tax base increase; allows for rate cuts	Tax base narrowing; may require rate increases
New investments	Decrease	Increase
BEPS reduction	Yes, if applied in a coordinated manner	Yes, if applied in a coordinated manner
Choice of capital structure	Reduces the debt bias but does not eliminate it	Neutrality towards debt and equity
Choice of organisational form	Neutrality with regard to organisational form	Possible influence on the choice depending on PIT

Source: Own Elaboration

5. Conclusion

In an increasingly globalised economy, individual countries face difficulties to finance their expenditure while maintaining competitiveness. Growing capital mobility adds to the existing challenges by placing large multinational enterprises at a more favourable position with regard to companies operating only in the domestic market. In particular, the uneven tax treatment of debt and equity goes against the classic principle that taxes should be neutral with regard to economic decisions. It gives rise to different types of economic inefficiencies and causes serious financial risks both to leveraged companies and the entire economy. In recent years considerable efforts have been concentrated to reforms in the area of company taxation, including through the implementation of measures targeted at reducing the debt bias in corporate financing decisions.

The two most important methods that have been used to address this asymmetry in tax systems are thin capitalisation rules and allowances for corporate equity. The application

of limitations on interest deductibility is the preferred approach by the OECD to address the debt bias and has already become the international standard. On its part, the system of allowance for corporate equity can be viewed as a feasible option to achieve a more neutral tax stance towards companies' capital structure. Its introduction has even been proposed by the European Commission as part of a EU-wide reforms of CIT.

The comparative analysis carried out in the present article confirmed that both thin capitalisation rules and allowances for corporate equity can successfully address some of the problems caused by the preferential tax treatment of interest, but the two methods also have their weaknesses, especially if applied in an uncoordinated manner. Moreover, a limitation in the present article comes from the separation of the debt bias from other elements in the design of corporate income taxation which also cause market distortions and tax avoidance, such as transfer pricing. Considering that the asymmetrical tax treatment of debt and equity is just one problematic aspect of CIT, future research can investigate the possible implications of more comprehensive international reforms of company taxation, including the introduction of common rules for calculation of the tax base.

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